



Paper tiger

New powers given to China's M&A regulator might have more to do with internal politics than discouraging foreign investment

The new Regulations on Foreign Investors Merging with or Acquiring Domestic Enterprises, which took effect in September, introduced a new national economic security (NES) test for cross-border M&A creating concern among foreign investors. But they needn't worry, at least in the near term.

The new NES test might impose additional self-discipline on foreign acquirers, as the acquisition of domestic market leaders with a commanding market share might not be politically feasible. But

this might not have been achievable under the old regime anyway.

The new NES rules are therefore not a signal that China is shutting the door to cross-border M&A, but the more politicized a proposed transaction becomes, the more likely it is that the NES levers will be pulled to block or modify the deal. This risk has always existed, but the political levers are perhaps more evident and might become more robust under the new rules.

The NES test looks at foreign acquisitions of domestic targets in “key industries” (not defined), acquisitions containing “elements that may affect national economic security” (not defined), or for change in control of “famous trademarks” (not defined in the M&A regulations but defined in international treaties and elsewhere in Chinese legislation) or “old established Chinese trade names/companies” (also not defined).

The NES review is completely opaque, giving the approval authorities (the Ministry of Commerce (Mofcom)) substantial discretion. This will, at the least, add a level of review that was not previously required, and at worst could provide another basis for political interference with commercial transactions. Many cite the delays experienced in the Carlyle acquisition of Xugong as evidence of a political backlash against foreign acquisitions of Chinese companies, but approvals of other such foreign acquisitions point to a less threatening conclusion.

It helps to view this issue in the context of the recent evolution of the Chinese market. Cross-border acquisitions of Chinese companies are a recent phenomenon – early foreign investment in China was limited to joint ventures in manufacturing. Wholly foreign-owned enterprises (WFOEs) originally were permitted only for export and high-tech manufacturing, but this was relaxed in the early nineties to permit WFOEs in more manufacturing, and even

some service, sectors (although they are still not permitted in more sensitive restricted sectors). By the late nineties WFOEs surpassed joint ventures as the foreign investment vehicle of choice in China. And with China’s entry into the WTO in December 2001, several other restricted service sectors have gradually opened to foreign investment.

Up to that point, cross-border acquisitions of Chinese companies were not common. The primary emphasis was on going it alone through WFOEs where permitted and accessing newly opened service sector markets pursuant to China’s WTO commitments. Chinese companies were deemed to present too much risk in terms of weak management and unknown liabilities, and too little upside in terms of product quality, brand value, market share and channels to market.

But since China’s accession to the WTO, the domestically driven economy in China has matured, changing the risk-reward equation for cross-border acquisitions of Chinese targets.

There are still risks – many unknown liabilities can still be assumed when buying a domestic company, and no foreign investor should underestimate the challenges in reforming management or operating systems in a domestic target company. But the upside of the equation has changed. More companies in China have built a product and marketing platform that can be more effectively leveraged by capital, technology, management systems and global market access of strategic (and in some cases financial) foreign investors. Foreign investors now see cross-border acquisitions as a key market entry vehicle when only a few years ago it would not have been a serious consideration.

But many foreign observers fear that, with the new NES review requirements, China is trying to close the door to cross-border M&A just as foreign companies are ramping up the

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M&A machine. The reality is that China has always had the ability to block (and has blocked) investments in sensitive sectors, and the related administrative hurdles were numerous and high (see box opposite). When reports of the new NES rules first circulated earlier in 2006, they seemed to be an unnecessary bolt-on to a system that already gave authorities seemingly unlimited discretion to reject a proposed foreign investment. For example, when selling state-owned companies, which constitute the largest market sector, the state can simply decide not to sell to foreign buyers – no special NES review is required.

So why have the new NES rules been adopted? Observers point to CNOOC’s failed bid to acquire Unocal as the trigger point. This was a highly politicized transaction on both sides of the Pacific. Many in the US saw CNOOC as a stalking horse for China’s attempt to take control of US oil reserves. Many in China saw the US Congress call for increased scrutiny of the acquisition on national economic security grounds as blatant political interference. After the CNOOC bid failed, government officials in China called for a similar NES review in China, even though several layers of control already existed.

But China’s concerns go beyond the problems faced by CNOOC in the Unocal transaction. In deciding to open its markets further under its WTO commitments, China also sought to support the development of domestic champions in the marketplace. As foreign companies increasingly acquired Chinese companies as a form of market entry or expansion, Chinese officials faced not only having Chinese companies competing head-to-head with foreign companies in the domestic market but also the transfer of control of leading domestic players to foreign investors.

Several layers of approvals were required even without NES review, but the Chinese central government authorities considered it necessary to pull that decision-making authority to the centre, to prevent local interests creating macro-level damage to

Chart 1: Cross-border M&A approvals process map

Target/seller	Process/approvals issues							
	Valuation	SASAC	PRE	CSRC	MOFCOM	NDRC	NES	Anti-trust
Listco target/ SOE seller	Takeover	Yes	No	Yes	Yes	Maybe	Maybe	Maybe
Listco target/ non-SOE seller	Takeover	No	No	Yes	Yes	Maybe	Maybe	Maybe
Non-listed SOE target	M&A/SAV	Yes	Yes	No	Yes	Maybe	Maybe	Maybe
Non-listed non-SOE target	M&A	No	No	No	Yes	Maybe	Maybe	Maybe
FIE target/ SOE seller	SAV	Yes	Yes	No	Yes	No?	No?	Maybe
FIE target/foreign seller (direct)	M&A	Maybe	Maybe	No	Yes	No	No	Maybe
FIE target/foreign seller (off shore)	N/A	No	No	No	No?	No	No	Maybe
Legend	M&A: 2006 M&A Regs		CSRC: China Securities					
Takeover: 2006 Takeover Regs	PRE: Property Rights Exchange		Regulatory Commission					
NES: National economic security review	SAV: State-Asset Valuation		NDRC: National Development					
	MOFCOM: Ministry of Commerce		and Reform Commission					

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China's competitiveness in its domestic markets. So the appointment of central Mofcom in Beijing as the sole authority to conduct NES reviews is only the latest manifestation of the power struggle between the provinces and the centre in China.

The NES provisions in the M&A regulations are hopelessly incomplete, a fact recognized by Mofcom authorities, who promise that more detailed implementing regulations will follow. Even with more detailed rules, it is not clear what practical impact NES review will have on cross-border acquisitions. The existing antitrust review for mergers (which covers not only inbound acquisitions of Chinese companies but also domestic M&A and even offshore M&A that could affect the Chinese market) has been in place in China since 2003, and almost 200 applications have been submitted to Mofcom. But Mofcom has not blocked any transaction to date.

So it seems Mofcom has been using the existing merger control filing requirements to learn the ropes. It might be that Mofcom has a similar experience with the new NES review, in which case it might turn out to be a paper tiger.

It seems unlikely that NES review is designed to curtail foreign investment generally. Mofcom has stated that it sees M&A as an important form of foreign investment in markets around the world and that, if anything, M&A is under-represented in the panoply of foreign investment vehicles in China. From its perspective, the M&A regulations are designed to provide a more stable platform for managing this inbound investment vehicle, which should be growing in importance in China.

Looking at China's overall continued openness to foreign investment (even with the barriers to market entry in several critical areas) together with the planned sell-down of state-owned companies in China and the lack of domestic capital to absorb all of the state assets sold off, the prospects for foreign players' continued cross-border acquisitions of Chinese targets are positive.

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China's foreign investment approvals - Difficult courses for typical horses

Having made the decision to invest in China by acquiring the equity or assets of a Chinese target company, the foreign acquirer should not only understand the regulatory framework in China applicable to the industry in which it operates, but should also understand the status and background of its potential targets and sellers. Different approval schemes will apply depending on the nature of the seller and target. (See Chart 1)

Below is a list of the most likely categories of possible targets and sellers:

- State-owned enterprise (SOE) seller of shares in domestic listed company;
- Non-SOE seller of shares in domestic listed company;
- Non-listed SOE target;
- Non-listed non-SOE target;
- SOE seller of equity interest in a foreign-invested enterprise (FIE);
- Non-SOE seller of equity interest in FIE;
- Foreign seller of direct equity interest in FIE;
- Foreign seller of shares in off-shore holding company investor in a China FIE;

The above are listed in order of decreasing difficulty, in terms of negotiation and completion of the deal.

The first level of enquiry should be whether you are dealing with a state-owned company or state-owned assets. If an SOE is the seller or the target in an asset or share sale involving a foreign investor, approvals from various authorities at the central or provincial government level, principally from the State-owned Asset Supervision and Administration Commission (SASAC), will be required. SASAC acts as the ultimate government shareholder in SOEs, so its approval is similar in nature to shareholders approval but tends to be more bureaucratic and less commercial. In many areas of China, SASAC officials are likely to be keenly interested in employee retention commitments and the long-term business plans and may insist that these be included by way of covenant in the acquisition agreement.

If the target is a listed company, it also needs to make mandatory disclosures as required by the China Securities Regulatory Commission (CSRC) and applicable stock exchange listing rules. If the foreign acquirer agrees to purchase more than a specified percentage (currently 30%) of the listed shares, the purchaser will need to make a tender offer for all or part of the issued share capital of the target company unless granted an exemption by the CSRC (which is becoming increasingly difficult to obtain except in very limited circumstances).

By contrast, if the seller is a foreign investor of an existing FIE, the transaction should be more straight-forward and

within the control of the buyer and seller. The easiest options would be for a foreign acquirer to acquire the interests of the foreign seller in an off-shore holding company, the sole asset of which is equity interests in a China FIE, since the transaction is done completely off-shore where Chinese authorities have no jurisdiction except for post-transaction registrations.

As a further general overlay, all foreign investment projects must conform to the requirements of the Foreign Investment Industrial Guidance Catalogue. The Catalogue groups foreign investment projects in specific industries and sectors in the following categories: encouraged, restricted and prohibited. Any foreign investment project not included in the Catalogue is deemed to be permitted. Different approval requirements apply depending on the classification of the project. The Catalogue also indicates whether there are limitations on the foreign ownership percentage in a project, for example projects in which 100% or majority foreign ownership are not permitted.

Statutory valuation requirements may also be imposed in certain circumstances. For example, any acquisition of state-owned shares or assets requires a valuation by a licensed valuer in China. The state asset purchase price typically cannot be less than 90% of the statutory valuation, although in practice the parties can influence the valuation result. State assets are also required to be sold via a state asset property rights exchange, which in theory should involve a public auction but in practice is mostly a time-consuming and expensive procedural nuisance that can be managed to achieve the commercial objectives agreed by the parties.

Cross-border acquisitions require a statutory valuation even if no state assets or shares are involved. Valuations in respect of public company takeovers are in practice tied to a 30-day average trading price value even if the seller is an SOE.

As shown on Chart 1, the line-up of approval authorities depends on the nature of the seller and target. The wild card is the National Development and Reform Commission (NDRC). Mofcom and the CSRC both take the position that NDRC approval is not approved in certain cases involving encouraged investment categories under the Catalogue and other cases, but the NDRC may not agree and you ignore the NDRC at your peril.

Anti-trust and NES review depends on whether the applicable thresholds are crossed, but to date the anti-trust filings appear not to attract any substantive review or administrative action, and NES review may prove to be similarly ineffectual in the near term.